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TAGS: ECON EFIN ELAB PGOV IT EUN KPRP ITALIAN POLITICS
SUBJECT: Italian Economic Policy and Challenges Under Berlusconi III

Ref: A) ROME 1409; B) ROME 1150; C) ROME 1043; D) 04 Rome 2630

SUMMARY

¶1. (SBU) By reluctantly agreeing to resign and form a new Government, PM Berlusconi bought himself and the governing coalition another year to convince Italian voters to re-elect them in 2006. Growing evidence indicates that a weak economy is a leading contributor to public dissatisfaction with the Berlusconi Government. However, budget woes will limit Berlusconi's ability to kick-start the economy through tax cuts or government spending. New Deputy Prime Minister Tremonti, who was ousted as Finance Minister in mid-2004, is the economic policy wildcard; and it is unclear how much of a role he will play in setting Italy's economic policy. The Government has sought to shift the blame for economic blues to procrustean eurozone monetary policy and cheap Chinese imports. Berlusconi will face the ire of the European Commission and sovereign debt markets, if deficit spending balloons significantly above three percent of GDP; but without additional pre-election pork, and some credible actions to improve voters' perception of economic progress, Berlusconi faces long odds at the ballot box. End Summary.

TREMONTI - THE KEY "NEW" PLAYER

¶2. (SBU) The new Berlusconi Cabinet, sworn in by President Ciampi April 23, was not that different from the one it replaced (Ref A). The key change affecting economic policy may be the return of ousted Finance Minister Giulio Tremonti as Deputy Prime Minister. In the first days of the newly formed Government, Tremonti made several economic proposals, including a ham-handed suggestion to raise revenue by leasing government-owned beachfront property in the underdeveloped south of Italy. (Comment: Retaining political support in the south is essential for Berlusconi to win in the next national elections. End Comment.) As Finance Minister, Tremonti relied heavily on one-off measures, such as tax amnesties, to shrink the budget deficit. His successor, Domenico Siniscalco, indirectly disparaged Tremonti's policies by declaring an end to creative public finance, and proposed the most sweeping budget reform package of the last decade. The dynamic between Tremonti, a political insider close to Berlusconi, and Siniscalco, a technocrat, but respected by the European Commission and the IMF (and, seemingly, the governing coalition, as well), will substantially affect Italy's economic policy over the next year.

OTHER NEW FACES...AND OLD FACES IN NEW PLACES

¶3. (U) Berlusconi also replaced three new ministers with portfolios related to economic policy: Communications (Mario Landolfi), Productive Activities (Claudio Scajola), and Health (Francesco Storace). Gianfranco Micciche' was named to the new Ministry (without portfolio) of Development and Territorial Unity. Micciche' will focus on strategies to help the south. See bios on these ministers in para. 17.

CONFLICTING DOMESTIC/INTERNATIONAL DEMANDS

¶4. (U) The Government faces conflicting demands 1) by voters (and some in the coalition), who want tax breaks, government jobs/pay raises, and relief from the impact of Chinese exports; and 2) by the European Commission and bond markets, which seek fiscal discipline, coherent and consistent economic reform, and a repudiation of emergency, one-off funding measures. The Government will be hard pressed to please either grouping, let alone both at the same time.

CHALLENGING ECONOMIC ENVIRONMENT; TEXTILES SLUMP
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¶5. (U) GDP growth has been anemic over the last three years, averaging just 0.6 percent annually. The Government has ratcheted down its 2005 growth forecast from 2.7 to a still-optimistic 1.2 percent. The manufacturing sector has had negative growth in six of the last eight quarters. Italian exports have become less competitive, in part because productivity increases have not kept up with wage growth. The textile industry, centered in the northern political base of Deputy PM Tremonti, has been hard hit. Italy has nearly 50,000 small textile companies, averaging about a dozen employees each and exporting well over half their goods.

JUGGLING BUDGET DEFICITS...

¶6. (U) On April 29, the Government revised its 2005 budget deficit forecast from 2.9 to 3.5 percent of GDP, putting it in line with earlier estimates by the IMF and European Commission. The Government also indicated that it would lower its stock of debt from 105.8 percent of GDP (end-2004) to 105.3 percent (end-2005). Both figures are in excess of the EU's ceilings of three percent of GDP (deficit) and 60 percent of GDP (debt). The Government will seek to convince the EU that the weak economy justifies exceeding the deficit ceiling, while telling voters that the economy is on the mend.

...AND DEBT

¶7. (U) Italy has been bringing down its stock of debt, thanks largely to low interest rates and privatizations. However, having already sold off its most attractive assets and with interest rates rising, the Government will strain to continue shrinking its debt. Until 1999, Italian government debt was held mostly by Italians. However, the trend has shifted since the introduction of the euro, and most Italian foreign debt is now held outside of Italy. Foreign bondholders will be watching closely for signs that the newly revamped EU Stability and Growth Pact will result in even greater divergence in fiscal policy among eurozone economies. If so, Italy's outlier status would translate into a higher risk premium on its sovereign debt. Standard and Poors has already downgraded Italian sovereign debt in July 2004.

COMPETITIVENESS PACKAGE TOPS ECONOMIC AGENDA.

¶8. (U) The Senate passed the first part of the Government's competitiveness package May 4, and it now moves to the Chamber of Deputies for expected quick consideration. The decree law includes provisions on corporate incentives, public works funding, bankruptcy reform, unemployment, and pension funds; and creates a new entity to promote foreign direct investment in Italy. On the revenue side, the package also increases alcohol consumption taxes, fines for purchasing knockoff goods, and penalties for employers hiring off the books. The second part of the competitiveness package is under consideration in the Chamber of Deputies as standard, not decree, legislation. Professional associations killed a provision that would have diminished their control over who can work in their occupation. Lack of open access to enter many professions causes distortions in the Italian labor market. In March, junior coalition partner the Northern League threatened to oppose the package if it did not address economic impact of Chinese textile exports. At the EU-level, the Government has sought help combating counterfeit goods and remediation for alleged textile dumping from China (Ref B).

"IRAP" BUMPS TAX CUTS OFF THE AGENDA.

¶9. (U) The European Court of Justice (ECJ) Advocate General issued an opinion March 17 that Italy's regional tax on productive activities (IRAP), a value-add tax on business, conflicts with EU legislation because the tax is too similar to the VAT. The ECJ will soon issue its ruling. If the ECJ rules that IRAP must be eliminated or changed, it would almost certainly include a phase-out period to keep from inducing a public sector funding crisis in Italy. Abolishing IRAP would slash 33 billion euro in GOI revenue.

¶10. (U) Finance Minister Siniscalco declared, "The Government has always considered IRAP inefficient and poorly conceived...Now the Government must replace it as soon as possible...to make firms competitive and in line with the EU Stability and Growth Pact." As the Government considers alternatives to replace IRAP revenue, it will have the opportunity to craft a tax alternative that will minimize market distortions on employers, investors, consumers, and

property owners. Confindustria, the Italian association of industrialists, has long called for abolishing IRAP and has recently pushed for elimination of any charge on labor/payroll in the taxes that replaces IRAP.

¶11. (U) Despite Italy's fiscal woes, Berlusconi continued his mantra of income tax cuts right up to the Coalition's lopsided defeat in the early April regional elections. Post-election analysis showed that tax cuts did not resonate with many voters, who were not convinced the cuts were sustainable into the future, and therefore, of little meaningful long-term value. Voters also realized that tax cuts would be accompanied by offsetting fees and service charges, which on balance left little extra money in their pockets. Finally, the tax cuts were not part of a systemic reform to make government spending more efficient and to reduce waste and redundancy in the bureaucracy -- changes that would have addressed key factors in Italy's economic stagnation and helped to stimulate the economy. Since forming the new Government, Berlusconi has been silent on future income tax cuts.

PROGRESS ON MARKET OVERSIGHT REFORM MAY SLOW.

¶12. (U) After the collapse of Parmalat in late 2003, then-Finance Minister Tremonti proposed sweeping market oversight reform legislation. Subsequently, the reform was divided into separate bills, the first of which was passed April 13, 2005, and implemented the EU Market Abuse Directive. The second tranche of the reform has passed the Chamber of Deputies and is under Committee review in the Senate (Ref C). However, since the Senate is likely to make changes to the bill, it would then need to return to the lower Chamber for reconsideration. Competing legislative demands to prepare the 2006 budget and pass voter-popular measures, will likely delay progress on oversight reform. If the Parliament does not pass the reform before dissolving for the 2006 elections, the reform package will be sent back to square one; and the next Government will need to submit a new bill for consideration.

¶13. (SBU) The version passed by the Deputies would create tough oversight on conflict of interest between banks and companies and requires banks to provide potential retail investors with a prospectus for bonds that the banks sell. Consob, Italy's securities market regulator, would gain powers in the supervision of auditing firms, while the financial police (Guardia di Finanza) would work more closely with Consob. The bill would make mega-fraud a new category of crime (fraud affecting more than 289,000 investors or holdings greater than USD 7.5 billion). The bill also puts limits on the credit that banks can extend to major shareholders (75 percent of the value of the shares the investor owns) and requires that company boards include an outside member who represents minority shareholders.

THE SOUTH...AND OTHER MEASURES ON THE HORIZON

¶14. (SBU) The Government will be looking for low/no-cost actions attractive to disaffected voters, especially in the Mezzogiorno South. One of the first of these, a proposal to raise revenue and increase tourism in the south by leasing Government beachfront property, was hurriedly conceived and poorly presented. (Comment: The presentation was reminiscent of the lack of consultation that contributed to Tremonti's resignation last year (Ref D). End Comment.) Rather than garner support in the south, the proposal was viewed by many in the target region as a sign that the Government was out of touch with the south and unwilling to take on core issues, such as infrastructure development.

¶15. (U) Separately, the public sector is pushing for a wage increase in 2005, which, if implemented, could increase the federal budget deficit by as much as 0.2 percent of GDP. Also, as a nod to the European Commission, the Government has discussed submitting to the Parliament earlier than usual the DPEF 2006-2009 (four-year budget plan) and 2006 budget. (Comment: DPEF is usually presented in July and the budget, at end-September. End Comment.) Early submission would give the Government an opportunity to demonstrate to the Commission that the excessive 2005 deficit was an anomaly.

COMMENT

¶16. (SBU) In 2001, Berlusconi swept into office as a reform-minded, practical businessman. Over the intervening four years, however, he has accumulated a spotty record (at best) of implementing the systemic reform Italy's economy badly needs. He will be even less likely to focus on reform over the next yeaQ especially the unpopular measures needed to rein in government spending and reduce bureaucracy. Despite Finance Minister Siniscalco's abhorrence of one-off measures, we expect the Government to look for quick fixes

to cut both the deficit and the debt. Whichever side wins the next national elections will still be confronted with the tough challenge of getting Italy's economy back on track. End Comment.

¶17. (U) BIOGRAPHIES OF NEW KEY MINISTERS

Giulio Tremonti, Forza Italia (FI), Deputy Prime Minister

Tremonti previously served as Finance Minister from June 11, 2001-July 3, 2004, when he resigned as a result of intra-coalition infighting. Tremonti is a tax law professor and a practicing attorney. Tremonti has more than twenty years of service teaching and cooperating with Governments of both the left and the right. In 1992, he was economic adviser to then-Italian Socialist Party (PSI) Prime Minister Giuliano Amato. Tremonti stayed in that position through 1994 with Amato's successor and current Italian President Carlo Azeglio Ciampi. During that time, Tremonti chaired the committee to streamline Italy's tax system.

In 1994, Tremonti was elected to the Chamber of Deputies under the centrist ticket "Patto Segni." He was appointed Finance Minister for the Government headed by Forza Italia's (FI) Silvio Berlusconi in 1994 and was not only a key economic adviser to the PM, but one of his closest political advisers, as well. He is President of the Aspen Institute Italy and speaks English well.

Claudio Scajola, Forza Italia (FI), Minister of Productive Activities
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In 1982, Scajola was elected Mayor of Imperia (region of Liguria); but in 1983, he was forced to resign as a result of a local corruption scandal, for which he was arrested briefly but later fully acquitted. Scajola was re-elected Mayor of Imperia in 1990. He was elected to the Chamber of Deputies with FI in 1996, and was re-elected in 2001. Scajola is one of Berlusconi's closest advisers. He was instrumental in deciding who to include in -- and who to exclude from -- FI's electoral ticket in the 2001 parliamentary elections.

In June 2001, Scajola was named Minister of Interior. In this capacity, he intensified the fight against international and domestic terrorism and organized crime. In June 2002, Scajola resigned as Interior Minister, after he was accused of offending the memory of Marco Biagi, a Labor Ministry adviser killed by the New Red Brigades. In November 2002, Berlusconi called on Scajola to coordinate the 2003 local elections, and on July 31, 2003, Berlusconi brought Scajola back into the government as Minister for Enforcement of Government Program. Scajola speaks French, but does not speak English.

Francesco Storace, National Alliance (AN) Health Minister

Storace was one of the promoters and founders of the National Alliance (AN) party, and formerly one of AN leader Gianfranco Fini's closest advisers. Tension has emerged between the two leaders, however. Storace was elected to Parliament in 1994, under Berlusconi's Freedom Pole (Polo della Liberta'), and re-elected in 1996. He was elected Vice President of the Chamber of Deputies' Oversight Committee on Radio and Television, and was a member of the Joint Parliamentary Investigative Committee on the Mafia. As a journalist, Storace headed the AN press office. Storace was elected President of the central region of Lazio (Rome's region) in April 2000, but lost his 2005 re-election bid. He speaks very little English.

Mario Landolfi, National Alliance (AN), Communications Minister
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The former AN spokesman is a relative lightweight in the Cabinet. As AN spokesperson, he has been a working level embassy contact.

Gianfranco Micciche' Forza Italia (FI), Minister (without portfolio) of Development and Territorial Unity (new office)

Until his recent appointment, Micciche was Deputy Finance Minister, where his portfolio included Economic Development of Southern Italy. Previously, he was Manager of the Regional Institute for Financing of the Industries of Sicily (IRFIS) for 11 years. He was the founder of Forza Italia in Sicily. Micciche' is a close advisor to PM Berlusconi, who appointed him National Vice Coordinator of Forza Italia in
¶2004.

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